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Dear Bill,

### **Pension Principles Consultation Document**

The recent increases in the cost of provision of defined benefit pension schemes is a matter for legitimate consultation. The cost of contributions to defined benefit schemes are affected mainly by:

- (i) increasing life expectancy,
- (ii) changes in the level of investment returns, and
- (iii) changes to pension scheme funding legislation.

With the exception of investment returns (which may improve in the future), it is unlikely that the other two factors will contribute to a future reduction in contribution rates. Therefore it may reasonably be assumed that the current level of contributions can be expected to continue leading to the requirement to be able to fund this level of contribution.

The Consultation Document notes (paragraph 1.6) that the pension principles were introduced by Ofgem in 2003 to protect licensees from the risk factors above.

The gas industry has already acted to reduce both industry and consumers exposure to these risks by closing DB schemes to new entrants with effect from 2002. Wales & West Utilities (“WWU”) support the pension principles, in general, and would welcome Ofgem’s confirmation of these principles over the long term to provide stability in an area which relates to a long term commitment to our employees.

In addition to responding to the specific questions which Ofgem raised in their Consultation Document, WWU consider it appropriate to put the consultation into perspective by giving some background on how the gas industry, and WWU in particular has arrived at the position it is in now.

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## **History of the WWU pension scheme**

WWU has a single pension scheme with defined benefit and defined contribution sections. The scheme was inherited as a mirror scheme from National Grid in 2005 as a condition of business sale. At the time the pension scheme was established it was consistent with other schemes for similar businesses under state control. WWU has not subsequently enhanced terms of improved benefits to members. Nor has the pension scheme been used to fund staff reorganisations. We understand that all the GDNs are in a similar position.

At 31 March 2008 there were 1,002 members of the defined benefit and 437 members of the defined contribution elements of the scheme. Of the defined benefit scheme membership 802 are currently contributing to the scheme, with the balance being either pensioners or deferred pensioners.

The defined benefit section of the scheme was closed to new members, three years before WWU was formed, in 2002 and consequently the current active membership is reducing as defined benefit employees retire. It is expected that by 2043 there will be no active defined benefit members, with the majority of the current active membership of the scheme expecting to become pensioners by 2035.

The defined benefit element of the scheme is managed under a Trust Deed which provides extensive powers and responsibilities to the Trustees. Changes to the Trust Deed require the consent of at least two thirds of the defined benefit members.

In accordance with the rules of the scheme the contribution rates which WWU pays across to the scheme are set by the scheme Trustees in consultation with WWU and must be certified by the scheme actuary. These contributions are intended to ensure that there are sufficient funds available in the pension scheme to pay an employee the pension to which he is entitled upon retirement. Where a pension deficit exists, the Trustees, together with the pension actuary, set the deficit contribution rate to recover such deficit over an agreed future period, consistent with the Guidance issued by the Pensions Regulator.

## **The cost of a defined benefit pension scheme**

The cost of a defined benefit pension scheme over the working life of an employee is a function of:-

- the employee benefits which are required to be funded,
- employee mortality,
- the investment strategy of the scheme,
- the investment performance of the schemes assets,
- administration costs, and
- the timing of cash payments into the scheme.

As discussed below, the Licensee company has limited influence or control over these cost drivers. The last GDN price control recognised that some costs, such as wholesale gas prices, are outside GDN management control, and established mechanisms to allow recovery of these costs, whilst incentivising management to be efficient where they have control. WWU believe that the current arrangements recognise these principles and should continue.

The actuarial assumptions used at triennial valuations have no immediate bearing on the overall cost. They are a means to estimate the current and likely future performance of the pension fund based on a set of assumptions. However, those assumptions will have a bearing on the amount and timing of payments into the scheme as they are used as the basis for deciding the contribution rate to be used for the period up to the next triennial valuation. Estimation errors in the assumptions used will be reflected and revised in the subsequent triennial valuation.

Looking at each of the functions of cost in turn:

#### *Benefits*

The benefits payable under the pension scheme were negotiated by the industry historically and are difficult to change. Changes require agreement of at least two thirds of the active members. A significant number of the members of the pension scheme also have protected rights and for these members the benefits cannot be changed.

#### *Employee Mortality*

Mortality rates are subject to a number of factors outside of control of the gas industry, and vary through time and by geography.

#### *Investment strategy*

Investment strategy is set by the scheme Trustees in consultation with the Actuary.

Investment strategies invariably assess rate of return against certainty of return. A “low risk” investment strategy may be perceived to result in increased cost through lower investment returns, but may ultimately be less costly than a high risk strategy which fails to perform and will ultimately require additional contributions to recover. A range of strategies might be assessed as “efficient” for each scheme, and the assessment of efficiency may vary between schemes depending on differing circumstances. Ofgem’s approach at the GDN price control of testing the investment strategies against a test of “reasonableness” remains appropriate.

Should Ofgem intervene into this process by defining an appropriate Investment Strategy for an industry or specific scheme, it would significantly change the balance of responsibility between the Trustees, the sponsoring company, the Pensions Regulator and the economic regulator. There would be no obligation for the Trustees to follow the economic regulator’s strategy. Trustees are responsible to the scheme members, and will receive actuarial professional advice. Each Actuary is likely to have a different view, depending on the specific circumstances of individual schemes (which are likely to diverge over time), than that from Ofgem arrived at through a generic industry approach. These different views (between the Trustees and the economic regulator), and consequential different funding requirements, would lead to a transfer of risk to the shareholders.

#### *Investment performance*

Investment performance is a direct result of the investment strategy and the cash available to invest. The sponsoring company is not able to influence this.

### *Administration costs*

Pension administration and actuarial advice is out-sourced by WWU. In a competitive market place, WWU regularly review their appointed advisers to ensure that administration costs are “efficient”. This efficient cost should be allowed to be recoverable from consumers.

### *Timing of cash contributions*

The timing of the input of cash to the scheme is driven by the schedule of contributions set by the scheme trustees in consultation with WWU and must be certified by the scheme actuary. The triennial valuation process, as explained above, is a means to “true up” the required contributions to a scheme over time to enable the scheme to meet its pension obligations as they fall due. This three year process seems to work well and has been accepted as a reasonable means of ensuring the adequate long term funding of defined benefit pension schemes in the UK.

With the average service lives of defined benefit employees will cover a number of triennial valuations and quinquennial price control review periods. Each of these triennial valuations can be expected to generate different ongoing contribution rates and deficit repair contributions (the economic and mortality assumptions at each valuation date potentially being different based on conditions at those valuations), all with the intention of achieving a fully funded pension scheme at the date the employees become pensioners. Thus it is likely that the pension burden will be spread over the service lives of the employees and therefore be charged to generations of consumers on a reasonably equitable basis.

### **Deficit Contributions**

Deficit repair payments, by their nature, are the recovery by the scheme of amounts that, with perfect foresight, should have been charged in earlier periods. Previous consumers have benefited from lower charges and future consumers will pay relatively higher charges to compensate. Assuming long term investment returns are equivalent to the discount factor used by Ofgem to assess pension funding, the cost to future consumers is reduced by funding deficit repair costs over as short a period as possible. Currently there is a disincentive to do this as any contributions in excess of current allowance have to be funded by shareholders – continued debate re pensions increases uncertainty that this money will be recovered.

### **Early Retirement Deficit Contributions**

As part of the on-going cost control measures implemented by regulated businesses to reduce costs, these companies look at opportunities to reduce employees through redundancy, with such reductions in costs benefiting consumers in the future.

An integral part of the cost of reducing employees through redundancy is the need to make early retirement deficit contributions as part of the employee’s termination package. There is only incentive on the regulated business to make such reductions provided the shareholders are not disadvantaged.

Given that the consumer will benefit from future reduced costs as a result of such reductions it is appropriate that the early retirement deficit contributions is an allowed cost as this is the current cost of achieving future savings.

## **Employer Covenants**

Employer covenants are likely to be similar across the industry due to the Licence requirement for GDN's to be rated investment grade by rating agencies. The Trustees are comfortable with WWU currently making deficit payments over a ten year recovery period.

## **Treatment of surpluses**

It is a responsibility of the Trustees to decide how surpluses should be handled. There may be guidance in the individual Trust Deeds of each pension scheme on how surpluses should be dealt with, however this is not an area within the control of the sponsoring companies.

Turning now to the Consultation Document itself:

### **Chapter three:**

#### ***Q1 Have we identified the key issues with the current pension principles?***

WWU believes that Ofgem has covered all the key issues with the exception of ERDCs which are discussed above.

#### ***Q2 Do the principles need amending, and if so, what changes are required?***

WWU believes that the principles of allowing the ongoing pension cash costs for the regulated business within the overall allowance together with the cash funding of the deficit, in general, to be appropriate.

WWU also believe that ERDCs should be allowed for the reasons set out above.

#### ***Q3 Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-X@20 review?***

The Consultation Document is discussing the principles of dealing with pensions costs rather than the impact of an RPI-X regulatory environment. WWU consider that such principles, if properly concluded upon should be valid under any form of regulatory control.

### **Chapter four:**

#### ***Q1 Should we set a generic deficit funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?***

WWU believe that Ofgem should allow the deficit to be funded over the period recommended by the particular scheme actuaries rather than a default ten year period. This is because there may be specific circumstance under which the deficit should be funded over a shorter period, i.e. the remaining average service lives of scheme members.

It is worth noting that Pension Regulators' guidance with regard to recovery plans refers to funding such deficits as soon as is reasonably practicable. As such there is not a "maximum assumed by the Pensions Regulator" period. The Pensions Regulator does operate a trigger point of ten years.

We also note that, under the recovery period is determined through discussions between the Trustees and the Company, with advice from the Actuary. The recovery period is approved and signed off by the Actuary. It is unlikely that the Actuary would sign off if the proposal was contrary to the views of the Pensions Regulator.

***Q2 Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period.***

As with our response to question two in chapter three above, WWU believes that the principles of allowing the ongoing pension cash costs for the regulated business within the overall allowance plus the cash funding of the deficit is appropriate.

As noted above, inevitably there will be some cross-subsidies between generations of consumers irrespective of the method of funding used due to the nature of the calculation of pensions funding requirements. Consumers would not necessarily be disadvantaged by any advance funding of the emerging deficit since such actions could be taken to ensure the most efficient operation of the scheme, giving rise to:

- increased investment returns as a result of funds being available to the Pension scheme earlier, and
- reductions in the PPF levy.

***Q3 Should ex-post adjustment be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes?***

Ex post adjustments should be by reference to the contribution rate, with the proviso that Licensees should not be penalised by being required to fund Early Retirement Deficiency Contributions when employment ends, and then additionally suffer an ex-post adjustment which recovers pensions allowance in respect of those employees who have left the company.

***Q4 What are respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?***

The efficient cost of constructing an infrastructure asset should be allowed into RAV. This includes normal pension costs. Deficit repair costs, as noted above, are in principle corrections to estimation errors in previous assessments of normal pension costs and should be recovered as an operating cash cost.

***Q5 Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved?***

Experience to date has indicated that it is possible to mitigate the impact of the risk based elements of the PPF levy. The PPF must ultimately raise a certain overall monetary amount, however, the division of this amount between participating schemes can be influenced by certain factors. Those organisations proactively managing the levy and more efficiently reducing the risk based portion of the levy than other businesses should see a comparative saving and therefore would tend to benefit over the long-term.

**Q6 Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review: and the treatment in RAV.**

Administration costs will vary depending on the different size and structures of schemes. Pension administration and actuarial advice is out-sourced by WWU. In a competitive market place, WWU regularly review their appointed advisers to ensure that administration costs are “efficient”. This efficient cost should be allowed to be recoverable from consumers.

Where a company can demonstrate appropriate management of the PPF levy then such costs should be allowed as pass through.

**Q7 Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?**

In order to avoid allegations of inconsistent treatment, it would be appropriate for at least outline rules & principles to be set out at an early stage and applied consistently over a period of time. It would, of course, be appropriate for such rules & principles to be modified as appropriate, and for those modified rules and procedures to apply going forward.

**Q8 Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?**

WWU do not believe that this is appropriate or possible. Within WWU there is no single dedicated workforce for the regulated activity and a separately identifiable workforce for the non-regulated activity. The same employees undertake both activities and their costs are accurately recorded through the appropriate use of timesheets. It would therefore not be possible for an actuary to undertake the proposal set out in the question as they would be unable to separate out the pension fund into regulated and non-regulated sections.

**Q9 Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?**

As pension deficit repair contributions represent accrued estimation error in respect of a cost that would have otherwise have been funded as “normal” pension cost under the pension principles, these should be allowed.

If you have any queries relating to this response please contact me as below.

Yours Sincerely



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